Supreme Court, U.S.
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(2)

No. 90-1389

In the Supreme Court of the United States

OCTOBER TERM, 1990

CLARK EQUIPMENT COMPANY AND
CONSOLIDATED SUBSIDIARIES, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the income tax deduction claimed by petitioner's wholly-owned subsidiary for the expenses it incurred in providing petitioner's stock to satisfy the conversion feature of the subsidiary's debentures was barred by Section 249 of the Internal Revenue Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 2a-12a) is reported at 912 F. 2d 113. The opinion of the district court (Pet. App. 13a-19a) is not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on August 22, 1990. A petition for rehearing was denied on October 3, 1990 (Pet. App. 1a). On December 17, 1990, the time within which to file a petition for a writ of certiorari was extended to and including March 4, 1991. The petition for a writ of certiorari was filed on March 1, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. On March 1, 1966, petitioner's wholly-owned subsidiary, Clark Equipment Overseas Finance Corporation (CLEO), issued debentures in the face amount of $15,000,000. The debentures, which had a stated annual interest rate of four and one-half percent, were guaranteed by petitioner. The debentures were convertible at the option of the holder into shares of petitioner's common stock at a conversion rate of $78 of principal amount per share of stock. After a two-for-one split of petitioner's stock, the conversion rate was adjusted to $39 of principal amount per share. The original indenture provided that petitioner was obligated to effect the conversions. On July 14, 1971, however, the indenture was amended to provide that CLEO, rather than petitioner, would effect the conversions. After the 1971 amendment, petitioner agreed to keep reserved at all times the full number of shares of its common stock needed to convert all of the outstanding debentures. Petitioner also guaranteed the due and punctual performance by CLEO of the obligation to convert. Pet. App. 3a, 13a-14a.

During 1973, the tax year in issue, the holders of debentures with an aggregate face amount of $1,447,000 exercised their right to convert their debentures at the rate of $39 of principal amount per share of petitioner's stock. CLEO purchased the required amount of stock from petitioner in order to complete the conversions.[1] The cost to CLEO of the stock provided to the converting debenture holders (along with small amounts of cash paid in lieu of fractional shares) totalled $1,839,989. Pet. App. 3a, 14a.

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[1] CLEO purchased the requisite number of shares from petitioner at a price equal to the average of the high and low prices for petitioner's stock on the New York Stock Exchange on the day of purchase (C.A. App. 19a-20a).

Petitioner and CLEO filed a consolidated income tax return for the tax year 1973. On that return, CLEO deducted as a loss the excess of the cost to CLEO of the stock and cash ($1,839,989) over the face amount of the debentures converted ($1,447,000). Upon audit, the Internal Revenue Service disallowed the claimed deduction of $392,989. Petitioner paid the resulting income tax deficiency ($188,634) and, after its administrative claim for refund was denied, filed this action. Pet. App. 3a-4a.

2. The district court held that the claimed deduction was barred by Section 249 of the Internal Revenue Code (Pet. App. 13a-19a). Section 249(a) provides in relevant part that "[n]o deduction shall be allowed to the issuing corporation for any premium paid or incurred upon the repurchase of a bond [or] debenture * * * which is convertible into the stock of the issuing corporation, or a corporation in control of * * * the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium." The district court concluded (Pet. App. 16a-17a) that the claimed deduction was for a "premium paid or incurred" to "repurchase" the debentures and was therefore barred by Section 249(a).[2]

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[2] The district court also rejected petitioner's argument that the effective date provision of Section 249 rendered the statute inapplicable (Pet. App. 17a-18a). Section 249 applies to any repurchase of a convertible obligation occurring after April 22, 1969, other than a convertible obligation "repurchased pursuant to a binding obligation incurred on or before April 22, 1969, to repurchase such bond * * * at a specified call premium." Tax Reform Act of 1969, Pub. L. No. 91-172, § 414(c), 83 Stat. 613. The district court concluded that CLEO had no binding obligation to repurchase the debentures until 1971, when the trust indenture was amended to provide that CLEO, rather than petitioner, would effect the conversions (Pet. App. 18a). The court of appeals agreed with the district court's conclusion (*id.* at 11a-12a). Petitioner has not sought further review of this issue.

3. The court of appeals affirmed (Pet. App. 2a-12a). The court held that the claimed deduction represented a "premium paid or incurred" equal to the excess of the repurchase price over the adjusted issue price, *i.e.*, the face amount of the debentures (*id.* at 6a-7a). The court concluded that the conversion of the debentures constituted a "repurchase" of them because "CLEO effected the conversions by paying money or its equivalent, shares of Clark stock, to the debenture holders to acquire the debentures" (*id.* at 8a). The court rejected petitioner's assertion that the amount CLEO claimed as a deduction was attributable to the cost of borrowing, concluding instead that it was attributable to the conversion feature of the debentures (*id.* at 8a-11a).

ARGUMENT

The court of appeals correctly held that Section 249 of the Internal Revenue Code barred the deduction claimed by petitioner's wholly-owned subsidiary with respect to the conversion of debentures of the subsidiary into petitioner's stock. That decision does not conflict with decisions of other courts of appeals. Indeed, as petitioner acknowledges (Pet. i, 9), the question presented here is one of first impression. Further review by this Court is therefore not warranted.

1. Section 249 was added to the Code in 1969 to clarify "the treatment of premiums paid by a corporation on the repurchase of its convertible indebtedness." H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 111 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 149 (1969). Congress enacted Section 249 to provide that a premium attributable to the conversion privilege, rather than to the cost of borrowing, is not deductible. Congress reasoned that "the amount of the premium which is in excess of the cost of borrowing is not analogous to an interest expense or deductible business expense, but rather is similar to an amount paid in a capital

transaction." H.R. Rep. No. 413, *supra*, Pt. 1, at 111; S. Rep. No. 552, *supra*, at 149. Accordingly, Section 249(a) provides that "[n]o deduction shall be allowed to the issuing corporation for any premium paid or incurred upon the repurchase of * * * indebtedness which is convertible into the stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium." Section 249(a) further provides, however, that a greater deduction may be allowed where "the corporation can demonstrate to the satisfaction of the Secretary that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature." This exception "is designed to allow for changes in the interest rates and to permit market and credit conditions to be taken into account." H.R. Rep. No. 413, *supra*, Pt. 1, at 111.

The court of appeals correctly concluded that the transaction in this case fell within the scope of Section 249. Each of the statutory conditions was present: (i) CLEO was the "issuing corporation" and the deduction was claimed on petitioner's consolidated return; (ii) CLEO effected a "repurchase" of the debentures by exchanging shares of stock (the equivalent of cash (Pet. App. 8a)) for the debentures;[1] (iii) the debentures were "convertible into the stock of *** a corporation in control of *** the issuing corporation," because they were convertible into the stock of petitioner; and (iv) the deduction was for a "premium paid." The premium with which Section 249 is concerned is a "premium paid" upon repurchase of a debenture "to the extent the repurchase price

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[1] The word "repurchase" means "to buy back or again: regain by purchase." *Webster's Third New International Dictionary* 1928 (1967). The word "purchase" means "to obtain (as merchandise) by paying money or its equivalent: buy for a price." *Id.* at 1844.

exceeds the adjusted issue price," which in this case was the face amount of the debentures. The excess of the $1,839,989 paid by CLEO (in stock and cash) over the $1,447,000 face amount of the debentures represented a conversion premium precisely of the type that Congress disallowed as a deduction under Section 249(a) (Pet. App. 7a). As the Tax Court explained in *Honeywell, Inc.* v. *Commissioner*, 87 T.C. 624, 642 (1986), when a convertible debenture is issued, "the interest rate market would have affected the determination of the conversion price." The amount paid for the debentures in excess of their face amount is thus "in satisfaction of the holder's conversion privilege and logically is attributable to that privilege and not to additional interest necessary to secure the proceeds of the original issue." *Ibid.*[4]

Petitioner's assertion that the $391,189 premium it paid upon conversion of the debentures represents "costs of borrowing" (Pet. 7) is factually unsupported. Under Section 249(a), petitioner had the opportunity "[to] demonstrate to the satisfaction of the Secretary" that the amount in question "is attributable to the cost of borrowing and is not attributable to the conversion feature." This provision permits "changes in the interest rates" and "market and credit conditions to be taken into account." H.R. Rep. No. 413, *supra*, Pt. 1, at 111. Petitioner made *no attempt*, however, either in its administrative claim for refund or in the district court proceeding, to demonstrate that the premium was attributable to its cost of borrowing. Petitioner thus wholly failed to meet the requirement of Section 249(a) that it demonstrate to the satisfaction of the Secretary that the

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[4] The purpose of Section 249 is to preclude deductions for amounts that are "in excess of the cost of borrowing" and, therefore, not "analogous to an interest expense or deductible business expense." H.R. Rep. No. 413, *supra*, Pt. 1, at 111; S. Rep. No. 551, *supra*, at 149. Such amounts are "attributable to the conversion feature of the indebtedness," rather than to the cost of borrowing. *Ibid.*

premium is attributable to the cost of borrowing, rather than to the issuance of its equity.

2. This distinction between premium attributable to the interest cost of borrowing and premium attributable to a conversion privilege is also present in Section 171 of the Code. Section 171(a)(1) generally allows a deduction for "amortizable bond premium," which is the excess of the taxpayer's basis in a bond over the amount payable at maturity (see § 171(b); Treas. Reg. § 1.171-2(a)). Section 171(b)(1), however, provides that the amount of deductible bond premium on a convertible bond shall not include "any amount attributable to the conversion features of the bond." In *National Can Corp.* v. *United States*, 687 F. 2d 1107 (1982), the Seventh Circuit disallowed a Section 171 deduction claimed by a parent corporation that issued its stock to convert the bonds of its subsidiary. The court held that the excess of the fair market value of the stock over the face amount of the bonds, represented a "premium" attributable to the conversion feature of the bond. *Id.* at 1113-1116. See also *Honeywell, Inc.* v. *Commissioner*, 87 T.C. at 640-642.[5]

There is no merit to petitioner's assertion that the decision in this case conflicts with *National Can* and with *Chock Full O'Nuts Corp.* v. *United States*, 453 F. 2d 300 (2d Cir. 1971), neither of which was decided under Section 249.[6] In

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[5] *National Can* and *Honeywell* were not decided under Section 249, because in each case a parent effected a conversion of its subsidiary's bonds into the parent's stock. See *National Can Corp.* v. *United States*, 687 F. 2d at 1115 (the parent "does not come strictly within the provisions of Section 249, since it was not the issuing corporation of [the subsidiary's] debentures"). As the Seventh Circuit concluded in *National Can*, however, Section 171 and Section 249 are "complementary" provisions (687 F.2d at 1114) and their policies are mutually reinforcing.

[6] There is likewise no merit to petitioner's assertion (Pet. 5, 7) that the decision below is contrary to Rev. Rul. 69-135, 1969-1 C. B. 198. That ruling was issued prior to the enactment of Section 249 by the Tax Reform Act of 1969, Pub. L. No. 91-172, 414(a), 83 Stat. 613.

National Can, the Seventh Circuit stated that in both Section 171 and Section 249, Congress drew a line "between bond premium that is attributable to the interest cost of borrowing and bond premium attributable to a conversion privilege." 687 F. 2d at 1115. In *Chock Full O'Nuts*, the Second Circuit concluded that "the taxpayer has failed to satisfy its burden of showing that the amount of the issue price aliocable to the conversion feature represents a cost of borrowing money that must without qualification be paid." 453 F. 2d at 304.[7] The courts in both cases thus distinguished between premium attributable to the interest cost of borrowing and premium attributable to a conversion privilege. The court of appeals applied the same distinction in this case and concluded that "the premium claimed by CLEO as a deductible loss is attributable to the conversion feature of the bonds" (Pet. App. 11a).[8] There is thus no conflict among the circuits that would warrant further review.

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[7] Other cases involving the treatment of convertible bonds under the original issue discount rules of Section 1232 have also recognized the distinction between the cost of borrowing and a conversion privilege and held that a conversion privilege in a bond does not give rise to amortizable discount. *AMF Inc.* v. *United States*, 476 F. 2d 1351 (Ct. Cl. 1973), cert. denied, 417 U.S. 930 (1974); *Hunt Foods & Industries, Inc.* v. *Commissioner*, 57 T.C. 633, 640-643 (1972), aff'd *per curiam*, 496 F. 2d 532 (9th Cir. 1974); *Honeywell, Inc.* v. *Commissioner*, 87 T.C. at 637-640.

[8] Even apart from the provisions of Section 249, there is an entirely separate reason why the deduction in question should be disallowed. If petitioner had effected the conversions itself, as the indenture originally provided (see page 2, *supra*), it is clear that petitioner would not have been entitled to any deduction for transactions involving the issuance of its own stock. *National Can Corp.* v. *United States*, 687 F. 2d at 1114-1117. Petitioner's use of its subsidiary, CLEO, to effect the conversions should not lead to a different result. CLEO served merely as a conduit between petitioner (which issued the stock) and the deben-

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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ture holder (who had the debenture to be converted into petitioner's stock). Indeed, prior to 1971, petitioner was obligated to effect the conversions itself. CLEO's role in the conversion process after 1971 served no independent business purpose and should therefore be ignored. See, *e.g.*, *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945) ("A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."); *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935).

☆ U.S. GOVERNMENT PRINTING OFFICE: 1991—282-061/20519